

APPENDIX

Notes for FOMC Meeting
December 22, 1992
William J. McDonough

The dollar has traded within narrow ranges of DM1.55 to 1.61 and 123 to 125 Japanese yen since the last meeting, finishing marginally lower against both currencies. The Desk did not intervene during that period.

Looking forward for the dollar, it appears that interest differentials with the DM and Japanese yen are likely to be stable, at least for short-term rates. The Bundesbank Council adjusted their M3 target zone upward by one percentage point to 4.5 percent to 6.5 percent, but seems committed to holding official rates at present levels. This view that German rates will not fall soon is the greatest change in market perception in the recent past and the main cause of the dollar weakening from about the DM1.60 level to about DM1.56, in recent days, with a strengthening today to DM1.58.

The Bank of Japan also seems firm on keeping the ODR [Official Discount Rate] where it is, amidst a growing belief that if additional stimulus is needed, it should come from the fiscal side through additional central government spending.

Although the dollar has been quite stable there has been continuing turbulence in European foreign exchange markets. Both Norway and Sweden ended their efforts to tie their currencies to the ECU and accepted floating as the only viable alternative. The Spanish peseta and Portuguese escudo were devalued by 6 percent in November and the Danish krone and Irish punt have been under steady pressure. The French authorities have managed to maintain the parity with the DM by very heavy verbal intervention and a rather large degree of market intervention by the Banque de France with some modest, but very public support by the Bundesbank. The European summit in Edinburgh kept the Maastricht Treaty alive by

large concessions to Denmark in the hope that the Danish people will endorse the treaty in a second referendum next year.

The market is now focusing on the French franc. Seven other currencies have been devalued against the DM since September, ranging from 6 percent for the escudo to 18 percent for the Italian, Swedish and Finnish currencies. This hurts the competitiveness of French economic sectors sensitive to trade and makes the market wonder how long the French can hold out in such circumstances, with unemployment already over 10 percent. On top of this economic problem, the French must cope with the reality that one of the lessons of the European Monetary System crisis is that the market focuses closely on political developments. This will almost certainly be the case in the next few months because of French parliamentary elections in March. Polls predict a win by the right and several prominent Gaullist Party politicians have been speaking out on the negative effects of maintaining the French franc-DM parity on the French economy. If the market assumes a victory by the right and hears more views questioning the parity, a serious test is likely. Last week, a preview of such testing was evident; the Banque de France had to intervene daily from Tuesday on, selling equivalent in foreign currencies to support the franc.

At the last meeting, the Committee approved the renewal for an additional year of the Federal Reserve System's reciprocal swap arrangements. All have been renewed.

Notes for FOMC Meeting
December 22, 1992
Joan E. Lovett

Reserve pressures were kept unchanged during the intermeeting period with Federal funds expected to remain in the area of 3 percent. The borrowing allowance was reduced by \$25 million to a level of \$50 million as seasonal borrowing continued to decline.

A large seasonal need for additional reserves was enlarged by a \$2 billion demonetization of SDRs by the Treasury on December 11 which it used to meet the IMF quota increase. In consequence, the cushion afforded by the expanded leeway requested at your last meeting proved very helpful indeed. The Desk met current and prospective needs during the period through purchases in the market of \$5 billion of Treasury coupon issues and \$2.5 billion of Treasury bills. A further \$3.2 billion of securities was purchased directly from foreign accounts, thereby using all but about \$400 million of the temporary \$11 billion leeway. The balance of the reserve need was met with temporary transactions; nine rounds of either customer-related or multi-day System repurchase agreements were arranged and, in the latter case, fixed-term agreements were used on several occasions.

Adjustment and seasonal borrowing averaged \$102 million for the period, elevated by a pre-Thanksgiving day bulge

of some \$800 million that occurred even though reserves seemed ample. The funds rate averaged 3.04 percent for the period, through December 20.

We anticipate the provision of additional temporary reserves through the year-end period and a bit beyond, but some reduction in our portfolio is likely to be needed by the time of your next meeting.

Market participants appear to be less stressed about year-end funding pressures as the nervous rush that developed in November has shown signs of abating as December progressed. Current reports have the Japanese banks paying about 6 percent for the turn of the year versus 13 to 14 percent earlier. Domestic banks are reported at 4 to 5 percent.

In the securities markets, yields on Treasury issues ended the period about 5 to 20 basis points lower amid some mild further flattening of the yield curve. Perceptions of the economy seemed to shift markedly, beginning with the upward revision of 3rd quarter real GDP growth to a 3.9 percent rate. Short-term market rates began discounting the increased demands for credit associated with an accelerating economy as well as prospective tightening by the Fed down the road. By early December, however, some of the earlier anxiety began to fade. A consensus on incoming data was forming that, while it showed

sufficient momentum to deter aggressive fiscal stimulus measures by the new Administration, it was not so strong as to threaten the gains made in reducing inflation. With this more optimistic view, market levels appeared "oversold," and there was a gradual improvement thereafter. Market participants generally feel that President-elect Clinton is obliged to follow through with a fiscal program but one that will be much more modest in scope than initially feared--\$25 - \$30 billion is heard fairly often.

While the approach of the year-end caused some diminution, trading flows were reasonably active. At this juncture, yields on Treasury coupon issues are actually quite close to levels prevailing at year-end 1991. The corporate and municipal markets were very active with new issuance quite brisk in both markets and pretty readily absorbed. Yield spreads to Treasuries were little changed for the most part.

Market participants currently see the recovery as unlikely to slip back or to roar forward. Consequently, no near-term change in System policy is expected. In this setting, some participants think short-term rates are too high, having been overly anticipatory of a firming move. News on inflation remains a positive influence. As a result, most participants seem to feel that it will be mid-year, at the earliest, before any change in System policy will occur. Estimates of real GDP growth in 1993 are tending to center at about 3 percent, with inflation running at 2 1/2 - 3 percent.

Michael J. Prell
December 22, 1992

FOMC BRIEFING

Last month, we noted several upside and downside risks to the economic forecast we were presenting. I think that it is pretty clear that, for the current quarter, the upside has been the winner.

As my Christmas present to the Committee, I'll spare you a lengthy repetition of the analysis you read in the Greenbook. Instead, I'll make just a few brief points on how we've interpreted the incoming data, beginning with those received since the forecast went to press last Wednesday.

The first major post-Greenbook news was the October merchandise trade release. As Ted will be discussing, that report indicates that real net exports probably will be higher this quarter than we anticipated. The second piece of news was yesterday's monthly Treasury statement for November, which suggested that the dropback in defense purchases may be sharper this quarter than we allowed for. On net, we view these two reports as offsetting in terms of their implication for fourth-quarter GDP growth--leaving us at 3.3 percent, about where we anticipated the third-quarter rate to end up after today's revision.

Obviously, a key issue for policy is whether the stronger pace of activity over the second half of this year will be maintained in 1993. It is our assessment that such an outcome, though clearly within the range of uncertainty attending any forecast, is not highly likely--absent an early fiscal or monetary stimulus.

This is not to say that the recent surprise has failed to impress us. Indeed, the stronger performance of the economy has led us not only to adjust upward the current level of output, but also to

raise the growth rates for the next few quarters. Employment appears to have firmed a shade more at this point than we had anticipated. And, where we thought that consumers would be hesitant to spend until job growth had picked up more noticeably, we seem to have gotten a headstart, partly on the basis of an election-related improvement in confidence about the outlook. This greater optimism could prove to be rather fragile; this may be especially so if our no-fiscal-stimulus assumption turns out to be close to the truth and people are banking on much more aggressive action. For the time being, though, the recent strength in demand, and the leanness of inventories, suggests that the economy will be carrying somewhat more momentum into the new year than we previously expected.

Still, we see this thrust as falling somewhat short of what may be necessary to sustain a 3.3 percent growth. One reason is the familiar laundry list of so-called "structural" drags, such as the decline in defense spending, the commercial real estate bust, and the problems of financial intermediaries. In addition, the continuing disappointing performance of the foreign industrial economies has left a significant imprint on the forecast. Were it not for the downward adjustment in foreign growth and the partly related upward adjustment in the path for the dollar, we probably would have had a slightly stronger growth forecast for 1993 and 1994.

But the flipside of that statement is that we likely would have had a slightly higher inflation forecast. As it is, we have raised our projection of CPI inflation a quarter of a percentage point or so, partly because of the upside surprises in the wage and price data of recent months and partly because of the tighter labor markets that have emerged and are expected to persist. We are still showing an appreciable moderation of inflation over the next two years, with

the CPI ex food and energy decelerating a full percentage point from its pace over the past twelve months. In this regard, I think it is fair to say that we remain on the optimistic side of the distribution of forecasters. For example, with an output and employment forecast very close to ours for next year, the Blue Chip consensus has the CPI rising 3.2 percent next year--with a quarterly pattern showing a hint of upward tilt. This difference of opinion is not new, and we've probably been "righter" on this score than others over the past year. But the twelve-month changes in such measures as the core CPI and average hourly earnings have flattened out some of late, suggesting that the situation does bear watching--particularly in light of the acknowledged upside risk to our forecast associated with our fiscal policy assumption.

Let me now turn the floor over to Ted for his comments.

E.M. Truman
December 22, 1992

FOMC Presentation -- International Developments

The October trade data, which came in after the Greenbook forecast went to press, were, as Mike has indicated, somewhat better than we had embodied in that forecast. However, not much of a surprise is left once one allows for the inherent volatility of the data, strips out the gold exports, which appear to have come largely from the coffers of the FRBNY and do not reflect current U.S. production, and notes that the surge in agricultural exports was largely in minor products. Consequently, we expect the November and December deficits to move back above \$8 billion per month, and we would make no significant change at this point in our outlook for 1993.

Relative to the last Greenbook, our outlook incorporates a further downward adjustment in near-term growth abroad; the reductions, on balance, amount to about 1/2 percentage point for growth in 1993 and somewhat less in 1994. The reasons are not new.

The balance-sheet adjustment process in the United Kingdom and Japan apparently will be more protracted than we had thought. In the U.K. case, the widespread phenomenon of negative equity in housing loans further complicates an already serious process of asset and debt adjustment. In Japan, the fiscal package has finally been passed, but new questions have arisen about the vigor with which stimulus will be pursued in the budget

for the next fiscal year starting in April; meanwhile, the Bank of Japan has held back from additional monetary ease. A bleaker outlook for final demand in Japan translates into larger questions about the health of the financial sector that, in turn, tend to damp any optimism about the real economy.

In continental Europe, the Bundesbank has declined to ease interest rates further at this time, despite uniformly gloomy news about the German economy. In most other European countries, with fiscal policies either restrictive or neutral and exchange rates still under pressure, the near-term prospects for stimulus are very limited. Not surprisingly, surveys of business and consumer confidence are increasingly negative. This pervasive malaise surely is associated with recent negative economic news; it may be associated with the continuing exchange market turmoil as well, and trade problems within the EC as well as with the United States and in the Uruguay Round add further to a sense of unease.

In Canada, there has been a resumption of growth, but the backup in interest rates associated with the recent bout of depreciation in the Canadian dollar plus the Mulroney government's determination to apply additional fiscal restraint suggest that the recovery will be moderate.

In the smaller industrial countries as well as in some of the developing countries, we are seeing some spillover of the effects of persistent slow growth in the major industrial countries.

In our outlook, the pickup in growth abroad does not gather much steam until the second half of next year. That pickup is predicated on several factors.

We are assuming that German short-term interest rates will decline by about 300 basis points by the end of 1993, with the bulk of the decline in the first half of the year; this is 100 basis points more than in our previous forecast. Interest rates in other European countries are expected to adjust downward as well.

We also assume that the Bank of Japan will ease further and that Japanese fiscal policy will be moderately stimulative.

While the process of balance-sheet adjustment will no doubt be protracted, its influence on the affected economies should begin to attenuate as seemingly has been the case in the United States.

Finally, relatively rapid growth in U.S. domestic demand should continue to spill over to the rest of the world.

The weaker outlook in the major foreign industrial countries, the assumed response of monetary policies to that weaker outlook, the improved outlook for the U.S. economy, and the modest upward revision in the path of dollar interest rates have induced us to impart an upward drift to the foreign exchange value of the dollar over the forecast period.

However, the amount of the dollar's drift is substantially less than that incorporated in many market forecasts; indeed, it is less than would be implied on average by current differentials in short-term interest rates. On the other

hand, there is a substantial positive discrepancy between most market forecasts of dollar interest rates and the interest-rate assumptions that form the basis for the Greenbook forecast.. Conditional on the staff assumptions, one might expect some downward pressure on the dollar as dollar interest rates fail to rise significantly.

Relative to the last Greenbook, our scaled-back outlook for growth abroad and the upward drift in the dollar substantially weaken an already negative forecast for the external sector. Net exports of goods and services on balance subtract about 1/2 percentage point from U.S. real GDP growth in 1993 and about a 1/4 of a percentage point in 1994. To reinforce a point that Mike made, the somewhat weaker staff outlook for U.S. real GDP going forward, compared with other forecasts, in large part reflects our lower outlook for growth abroad rather than a more negative assessment of domestic demand.

The projected deterioration in the U.S. trade balance is somewhat smaller than that in real net exports, largely because of the effects on our terms of trade of the stronger dollar and lower oil prices. However, the projected trade deficit in excess of \$150 billion at an annual rate by the fourth quarter of 1994 would put it back above 2 percent of nominal GDP. This would be about twice the recent low point in the first quarter of this year and, at some point, could become troublesome politically, if not financially.

I will stop on that sour note.

December 22, 1992

FOMC Briefing
Donald L. Kohn

In some contrast to direct readings on the economy, financial developments have presented a more mixed picture with respect to emerging trends in spending, perhaps supportive of some caution in assessing the outlook. Interest rates, though not greatly changed in most cases over the intermeeting period, along much of the yield curve are still nearly 1/2 percentage point above their recent lows in early October. The pattern for the dollar's exchange rate has been similar; on a weighted average basis it is 14-1/2 percent above its September trough. To be sure, these increases reflect a more positive outlook for the economy and associated increases in credit demands. But the strength in the dollar also is associated with weakness abroad, as Ted discussed. Moreover, the near-term slope of the interest-rate yield curve suggests expectations of a substantial rise in short-term rates over 1993, by as much as two percentage points--considerably more than built into the projections not only of Board staff but of most outside economists as well. The steep slope of the yield curve may suggest that intermediate-term rates have over-reacted to encouraging news, with partially self-defeating results. A positive development over recent weeks has been the drop in long-term yields, even as Treasury bill rates were stable. Occurring in the context of good economic news, this decline may reflect more optimism on the prospects for long-term deficit reduction or low inflation, with at worst neutral and possibly positive implications for incentives to spend over the next year or so.

Private credit flows appear to have picked up a bit in recent months, supporting stronger spending. However, some of the recent

increase in business short-term borrowing, which accounts for much of the uptick, seems to owe to earlier-than-usual efforts to lock in year-end funding in advance, and bank loans and commercial paper have weakened in early December. Attempts to nail down finance may reflect lingering concerns about skittishness on the part of lenders, many of whom are still under considerable financial pressure. Some of the increase in household borrowing may be associated with the surge in mortgage refinancing, as homeowners take advantage of the opportunity to realize cash against their equity, in part to cover settlement costs. In any event, growth of the debt of private borrowers remains below that of spending, suggesting continued caution in credit supply and demand and ongoing efforts to rebuild balance sheets.

If a revival of M2 and a slowing of its velocity growth was expected to be an indicator of a return toward more normal financing patterns and rate spreads, the most recent information on the expansion of this aggregate is not encouraging. Several special factors--including the First Union NOW account shift and mortgage refinancings--have obscured underlying trends in the monetary aggregates in recent months. It now appears that the refinancing effect was greater in October and November than we had estimated, and the underlying trend in M2 correspondingly lower. We expect that the volume of refinancings will decline and subtract from M1 and M2 growth over coming months. Partly for this reason, we have projected growth in M2 of only 1-1/2 percent under alternative B from November to March. The slowdown compared to recent months is concentrated in its M1 component, which is most affected by the special factors. M1 is expected to increase at a 5-3/4 percent rate between November and March, after double-digit growth for most of 1992. Abstracting from special factors, we are looking at M2 growth on the order of 2-1/2 percent from

November to March; this compares to estimated underlying growth of 2 percent from June to November. Our evaluation of M2 and forecast of its growth imply that the trend of appreciable increases in its velocity remains intact. Thus we see quite damped M2 growth as consistent with the greenbook forecast.

If, nonetheless, actual and prospective sluggishness in M2 and modest growth of credit were seen as signs of persistent underlying financial problems, which raise the odds that weaker spending could re-emerge, then retaining the current asymmetrical tilt in the directive might seem appropriate. In addition, the possibility that the recent surge in optimism could be reversed if events don't match rosier expectations, and the continuing risks of even gloomier outcomes abroad, also might support the view that more rapid policy responses to signs of weakness than of strength remain appropriate, especially in light of the considerable slack and disinflationary forces still operating on the economy.

If, on the other hand, the more robust trend to spending and confidence--even in the face of weak money growth--the possibility of stimulative policies by the incoming administration, and the less encouraging tone of some recent inflation data were seen as suggesting that the risks to sustainable growth and damped inflation were more evenly balanced now, the Committee might want to shift to a symmetrical directive.

Such a directive would imply that the Committee viewed the next change in reserve conditions as equally likely to be toward the tightening as the easing side. Although the current yield curve may exaggerate the rise in short-term rates likely to be associated with sustainable economic expansion, the odds are high that an increase in the federal funds rate will be required at some point in the expansion; in

the greenbook forecast it begins in 1994. Certainly, real short-term rates, still close to zero, seem unsustainably low. The appropriate size and timing of an increase in real rates obviously depends on how rapidly the financial and other factors previously impeding expansion ebb. The needed increase would come sooner and be larger if the new administration puts in place policies--not only in the area of fiscal policy, but perhaps also with respect to encouraging bank lending--that have the effect of boosting aggregate demand substantially.

A sufficient rise in real rates likely will entail a rise in nominal rates, unless inflation and inflation expectations diminish faster than now expected. The difficulty that at some point in the future will confront the Committee will be to begin the process of tightening sufficiently early to consolidate and build on the gains against inflation. Given the lags in the effect of policy actions, this process will need to begin before the economy approaches potential, while inflation may still be headed down. This will be particularly difficult in the absence of a monetary aggregate that the Committee is confident has a reliable connection to spending over time.